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IN THE

Supreme Court of the United States

October Term, 1965

No. 1053

DONALD D. RANDAL and JEAN E. RANDALL, ESTHER FENDER, JEAN E. RANDALL, DONALD D. RANDALL, C. LEO FENDER,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioners by their counsel pray that a Writ of Certiorari issue to review the decision of the United States Court of Appeals for the Ninth Circuit, which reversed the decision of the Tax Court of the United States and opinion of the United States Court of Appeals for the Ninth Circuit was filed and entered on December 1, 1964.

Opinions Below.

The opinion of the United States Tax Court in support of its judgment is appended hereto and marked "Appendix I".

The opinion of the United States Court of Appeals for the Ninth Circuit is appended hereto and marked "Appendix II", which opinion is reported at 338 F. 2d 924.

Jurisdictional Statement.

On December 1, 1964, the United States Court of Appeals for the Ninth Circuit entered its judgment in Commissioner of Internal Revenue v. Fender Sales, Inc., Donald D. Randall and Jean E. Randall, Esther Fender, Jean E. Randall, Donald D. Randall, and C. Leo Fender, consolidated in C. A. Ninth No.'s 19074-19079. The Commissioner had appealed Tax Court decisions favorable to all taxpayers. The Court of Appeals reversed the Tax Court as to the individual taxpayers (No.'s 19075-19079) but affirmed as to the corporate taxpayer, Fender Sales, Inc. (19074). The individual taxpayers filed a Petition for Rehearing in the Ninth Circuit, which was denied on January 14, 1965; thus the tme within which they may file a Petition for a Writ of Certiorari will expire on April 14, 1965.

The jurisdiction of the Supreme Court of the United States is invoked pursuant to the terms and provisions under 28 U.S.C. Section 1254, subdivision 1.

Questions Presented.

1. Does the receipt of the individual taxpayers, Fender and Randall, who were at all times pertinent to this proceeding, equal Fifty (50) per cent shareholders of Fender Sales, Inc., of equal distributions of common capital stock from Fender Sales, Inc. in cancellation of Fender Sales, Inc. salary indebtedness to them constitute taxable income?

2. Were the petitioners deprived of the rights guaranteed by the Fifth Amendment and the Sixteenth Amendment to the Constitution of the United States by the decision of the United States Court of Appeals for the Ninth Circuit which taxes petitioners despite their having realized no economic gain?

Constitutional Provisions, Statutes and Regulations Involved.

Internal Revenue Code of 1954, Section 61(a) Gross income defined.

> "(a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> (1) Compensation for services, including fees, commissions, and similar items.
>
> * * *

Treasury Regulations on Income Tax, Section 1.61-1(a) Gross Income.

> "(a) General definition. Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of illustration. For purposes of further illustration, Sec. 1.61-14 mentions several miscellaneous items of gross income not listed specifically in Section 61. Gross income, however, is not limited to the items so enumerated." 26 C.F.C., Sec. 1.61-1.

Fifth Amendment to the Constitution of the United States:

> ". . . nor be deprived of life, liberty or property without due process of law; . . ."

Sixteenth Amendment to the Constitution of the United States:

> ". . . The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

Statement of the Case.

The facts pertinent to the appealed issues, as found by the Tax Court, some of which were stipulated [R. 3-4, 5, 14-20], may be restated as follows:

The taxpayer, Fender Sales, Inc., was incorporated in 1953 as a California corporation. It was authorized to issue 2,500 shares of common stock with a par value of $100 per share. At the commencement of the events material to this case only 100 shares were outstanding, 50 of which were held by the taxpayer Donald D. Randall and the other 50 by the taxpayer C. Leo Fender [R. 39-40]. Randall and Fender were also employees of Fender Sales and as such were entitled to receive, as compensation for their services, $15,000 a year plus amounts equal to four percent and one percent, respectively, of annual sales [R. 39-41].

Although Fender Sales has always been financially solvent [R. 43], from its inception it has been plagued by a shortage of cash. This financial predicament was brought about primarily because it had to pay for its purchases upon receipt of the merchandise while it was often required to finance the dealers who purchased merchandise from it. Accordingly, in 1955 Fender Sales found it necessary to seek bank financing. Originally, the bank did not ask for security for its loan, but later

it required the subordination of other liabilities and personal guarantees from the corporate officers. In addition, it became concerned about accrued (but unpaid) officers' salary liabilities that appeared on Fender Sales' balance sheet; it felt that these liabilities could represent potential priority claims over the bank's claim. To remedy this the bank suggested that these liabilities be capitalized [R. 41].

In each of its fiscal years ending May 31, 1954, 1955, and 1956, Fender Sales, which used the accrual method of accounting for federal income tax purposes [R. 27], accrued $30,000 on its books of account as representing officers' salaries payable, but unpaid, in the amount of $15,000 a year each to Randall and Fender. In each of those years, Fender Sales deducted the $30,000 on its federal income tax return. Accordingly, as of August 6, 1956, Fender Sales owed Randall and Fender each $45,000 for salaries payable for the fiscal years ended May 31, 1954, through 1956 [R. 40-41].

On or about August 6, 1956, Randall and Fender in order to comply with the bank's suggestion, offered to discharge Fender Sales' liability for salaries due and payable to them by accepting from Fender Sales an additional share of $100 par value common stock for each $100 of salary debt. On August 6, 1956, the board of directors of Fender Sales, consisting of Mr. and Mrs. Randall and Mr. and Mrs. Fender [R. 39-40], resolved to accept the offers by Randall and Fender. After obtaining a permit from the Commissioner of Corporations of the State of California, Fender Sales on December 3, 1956, issued to Randall and to Fender 450 shares each of its $100 par value common stock in discharge and cancellation of its indebtedness of $45,000

owing to each of them. As a result of this issuance of stock, Sales' capital stock account was increased from $10,000 to $100,000 and its $90,000 liability for salaries owed to Randall and Fender was discharged and cancelled [R. 42].

During the fiscal year ended May 31, 1957, Fender Sales accrued on its books of account $30,000 which represented officers' salaries payable, but unpaid, of $15,000 each to Randall and Fender. Fender Sales deducted this amount of $30,000 on its federal income tax return for the fiscal year ended May 31, 1957 [R. 42].

On or about February 3, 1958, when Fender Sales was still indebted to Randall and Fender for $15,000 each for salary for the fiscal year ended May 31, 1957, Randall and Fender offered to discharge Fender Sales' liability for salaries due and payable to them by accepting from Fender Sales an additional share of $100 par value common stock for each $100 of salary debt. On February 3, 1958, the board of directors of Fender Sales resolved to accept the offers by Randall and Fender. On May 9, 1958, Fender Sales issued to Randall and Fender 150 shares each of its $100 par value common stock in discharge and cancellation of its indebtedness of $15,000 owing to each of these individuals. On the same date, it issued to Randall and Fender 350 shares of its $100 par value common stock as a stock dividend. As a result, Fender Sales' capital stock account was increased from $100,000 to $200,000, its earned surplus account was decreased $70,000, and its $30,000 liability for salaries owed to Randall and Fender was discharged and cancelled [R. 42-43].

On their federal income tax returns for the years 1956 and 1958, Fender and his wife did not report any

amount as taxable income resulting from Fender's receipt of 450 shares of Fender Sales stock on December 3, 1956, and 150 shares of Fender Sales' stock on May 9, 1958. On their federal income tax returns for the year 1956 and on their joint federal income tax return for the year 1958, Randall and his wife did not report any amount as taxable income resulting from Randall's receipt of 450 shares of Fender Sales' stock on December 3, 1956, and 150 shares of Fender Sales's stock on May 9, 1958. On its corporate federal income tax returns for the fiscal years ended May 31, 1957, and May 31, 1958, Fender Sales did not report any amount as taxable income resulting from the discharge and cancellation on December 3, 1956, and May 9, 1958, of its indebtednesses for officers' salaries payable to Fender and Randall [R. 43-44].

The Commissioner determined that the receipt of the stock constituted taxable salary income to Fender and Randall and, alternatively, that, if it did not constitute taxable income to them, Fender Sales realized taxable income upon the cancellation of the salary indebtednesses. The Tax Court held, however, that the cancellation of the indebtednesses and issuance of the stock did not result in taxable income either to Fender and Randall or to Fender Sales [R. 66-68, 69-71, 72-24].

Reasons for Granting the Writ.

1. A review of some of the decided cases reveals that the United States Supreme Court may grant certiorari where principles are involved which are of public rather than private importance. In the instant case, petitioners submit that the decision of the Court of Appeals for the Ninth Circuit, if allowed to stand, would

indeed overturn a *fundamental principal of taxation basic under the Sixteenth Amendment* to the Constitution of the United States that a mere appreciation in the value of an asset is not subject to income tax.

Our Supreme Court has always upheld the right of the American taxpayer to avoid the recognition of tax on economic gain represented by increase in the value of his assets until the increase in value has been realized by a sale or other disposition. A piece of land is purchased and held. After the passage of a few years, it is perhaps doubled or trebled in value, but so long as the taxpayer merely holds the land, and despite the betterment of his economic position, no tax is due. The Courts have always said that in such a case *no tax shall be imposed as there has been no realization.* In fact, *this is the basis for the favorable capital gains rates; i.e.,* so that a taxpayer will not be unduly penalized by realizing in one year an economic gain which in fact took place over several years. Petitioners submit that the decision of the Court of Appeals for the Ninth Circuit in the instant case is in direct and unequivocal conflict with that basic rule. The impact upon the taxpaying public and their professional advisers of a decision qualifying this basic fundamental rule of taxation; *i.e.,* that a mere appreciation in value is not subject to taxation, is easy to predict. What is the lawyer, the accountant, the banker or other professional and business advisers, to advise their clients as to whether or not they, too, may be subject to imposition of income taxes where unsuspectingly they have relied upon this fundamental doctrine that a mere increase in value is, without more, not subject to income tax. If a taxpayer can be taxed for an asserted increase in value in his

shareholdings, why indeed may not the farmer be taxed upon wheat that grows in the field? Why must the taxable event be postponed until the wheat is harvested and sold? Why, indeed? *The taxation of unrealized appreciation in value is completely foreign to our body of American taxation law and to our basic economic system.*

2. In Paragraph 1 above, the discussion has been predicated upon an asserted and purported increase in value. Petitioners submit that another and equally important fundamental principle of taxation is cast aside by the decision of the Court of Appeals for the Ninth Circuit, if allowed to stand. *It has been assumed in Paragraph 1 above* that an appreciation in the shareholdings of the petitioners occurred as a result of the petitioners relinquishing their unsecured right to receive payment in cash for services rendered. The majority decision enunciated a legal and economic concept of devastating proportions when the proposition was put forth that "petitioners have *retained* (emphasis added) an equal interest in a substantially different investment." Stated differently, petitioners are held to have received *the increase in the corporate net worth by retaining what each of them already owned*, to wit, a fifty per cent (50%) interest each in the common capital stock of their corporation. But is it not true that this description would fit equally well a shareholder who retains his interest in a corporation which has earned a profit through operations? Are we to tax such a shareholder in like manner? As illustrated in Paragraph 1 above, there has been no realization of economic gain. As illustrated below in this paragraph, *there has not been an increase in the net worth of the petitioners.*

Prior to the transaction in question, each of the petitioners, Donald D. Randall and C. Leo Fender, owned a fifty per cent (50%) interest in the common capital stock of the corporation. Prior to the transaction, the corporation owed each of the petitioners certain sums for services rendered. After relinquishing their chose in action against the corporation for compensation for services rendered, each owned the same fifty per cent (50%) interest. After the relinquishment of the chose in action, said petitioners' net worth was reduced, and the corporation's net worth was directly and proportionately increased. Said petitioners not only did not realize any economic gain *but in fact suffered an economic loss. Thus, petitioners are being subjected to taxation while individually suffering a reduction in their net worth.* This is the first case known to the petitioners which taxes a *creditor* who has forgiven an obligation. There may be other aspects of this case which are arguable, but surely it would be difficult to dispute the truth of the analysis and propositions set forth in this paragraph. The imposition of tax in the absence of economic gain pursuant to the decision of the Court of Appeals for the Ninth Circuit, petitioners submit, violates the Sixteenth Amendment and the Due Process Clause of the Fifth Amendment to the Constitution of the United States.

3. As a separate and distinct ground for granting this Petition for a Writ of Certiorari, petitioners submit that the Court of Appeals for the Ninth Circuit has misconceived and misapplied the decisions of this Court in *Eisner v. Macomber,* 252 U.S. 189 (1920), and *Helvering v. Horst,* 311 U.S. 112 (1940). Petitioners submit that *Eisner v. Macom-*

ber, cited by the U.S. Tax Court, stands for the proposition that no income is taxable and realized by a stockholder who receives additional shares of common stock which do not affect any change in the shareholders' proportionate interest in the corporation. In distinguishing *Eisner v. Macomber,* the Court of Appeals stated that the only reason a stock dividend does not constitute a taxable income under the Sixteenth Amendment to the Constitution is because *no change is made in the basic net worth of the corporation.* The Court emphasized that the stock dividend in the *Eisner* opinion is "paper certificates that represent an antecedent increase in the value of the stockholders' capital interest." Petitioners submit that this is manifestly a misapplication of that case. In fact, petitioners submit, *Eisner v. Macomber,* stands for the proposition that no taxable income is realized by a shareholder until a dividend has been paid *which alters the proportionate interest of the shareholder* or a sale has been made of his corporate stock. As Judge Barnes points out in his dissenting opinion in the instant case, "This majority opinion is the first I have encountered which recognizes a realization of income by shareholders upon an increase in corporate net worth, *where no dividend has been declared or capital gain yet realized* by the shareholders." Petitioners further point out that in the instant case the increase in corporate net worth, occasioned by the relinquishment by the petitioners of their unsecured right to receive salaries, did not create corporate earnings but was a non-taxable contribution to capital as decided by the Court of Appeals' own decision in *Commissioner v. Fender Sales, Inc.,* 338 F. 2d 924, a companion case. There was no increase in the

corporation earnings and profits and consequently no tax was imposed upon the corporation. How is it possible then that the shareholders can be taxed on a non-taxable increase in the corporate net worth?

Petitioners respectfully assert that the Court of Appeals for the Ninth Circuit misapplied *Helvering v. Horst,* erroneously failed to apply *Eisner v. Macomber,* and misapplied *Lidgerwood Mfg. Co. v. Commissioner,* in an effort to close an asserted loophole which allows a corporation whose stock is owned equally by two principals to take deductions in certain years for accrued salaries payable, never pay off such liabilities in cash, and then have the liabilities written off without any tax recognition to the corporation because the item is treated as a capital contribution by the shareholders. Judge Barnes submits that if such a loophole exists it should be closed by legislative action and not by judicial fiat.

Petitioners point out that *the issue of salary deduction was never raised by the government* and they in fact stipulated to the deduction as an ordinary and necessary business expense. It is respectfully submitted that the decision of the Court of Appeals for the Ninth Circuit incorrectly applied the case of *Helvering v. Horst* which involved an assignment of income rights to others prior to the point of realization of income by the taxpayer himself. As stated by Judge Barnes in his dissenting opinion, "Taxpayers here have had no benefits *realized* by the issuance of additional stock for the cancellation of a corporate debt; their income has not been diverted to any one else for their own personal benefit. They did not exert any power to dispose of their alleged 'income' in a manner equivalent to owner-

ship, and will not do so until the ordinary taxable event occurrs—the sale of their stock."

Thus, it appears that a plain meaning of the decisions of this Court in *Helvering v. Horst* and *Eisner v. Macomber* are being distorted by misapplication in order to indirectly disallow a deduction properly taken in accordance with the applicable taxation regulations and acquiesced in by the taxing authorities in their failure to register a proper challenge thereto. Petitioners respectfully submit a misapplication of prior decisions of the U.S. Supreme Court as a proper ground for granting of the requested writ.

4. The Supreme Court of the United States may grant certiorari in the event of a conflict of opinion among the various Courts of Appeal. The dissenting opinion of Circuit Judge Barnes clearly sets forth the conflicts between Circuit Court opinions. Petitioners respectfully assert the decision in the instant case is in direct conflict with the decision of the Court of Appeals for the Second Circuit in *Lidgerwood Mfg. Co.* and of the Sixth Circuit in *Bratton v. Commissioner* as quoted by Judge Barnes, ... "to the extent the Lidgerwood case is relevant to the facts before us, it supports the conclusion the taxpayers have not yet realized income by the receipt of additional shares of stock (while maintaining their identical proportional interest) for a debt cancellation."

Conclusion.

For the foregoing reasons, the Petition for Certiorari should be granted.

Respectfully submitted,

WILLIAM C. JORDAN,
Attorney for Petitioners.

APPENDIX I.

Opinion of the United States Tax Court.

T. C. Memo. 1963-119

Tax Court of the United States

Fender Sales, Inc., et al.,[1] Petitioners v. Commissioner of Internal Revenue, Respondent.

Docket Nos. 92757, 92758, 92759, 92760, 92761, 92762, 947-62. Filed April 26, 1963.

Held, petitioner C. Leo Fender was not taxable on bonus payments received in 1956 and 1957 to the extent such bonuses were returned in the year of receipt to his employer.

Held further, petitioner Fender Instrument Co. did not understate its salary expense deduction in the year 1956, and it did not overstate its miscellaneous income in the year 1957.

Held further, petitioner C. Leo Fender received taxable income in the amount of $40,000 as a result of the withdrawal of said sum in 1958 from Fender Instrument Co.

Held further, petitioners Donald D. Randall and C. Leo Fender did not realize taxable income in 1956 and

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[1]Proceedings of the following petitioners are consolidated herewith: Donald D. Randall and Jean E. Randall, Docket No. 92758; Esther Fender, Docket No. 92759; Jean E. Randall, Docket No. 92760; Donald D. Randall, Docket No. 92761; C. Leo Fender, Docket No. 92762; and Fender Electric Instrument Co., Inc., Docket No. 947-62.

1958 upon the receipt of additional common stock from Fender Sales, Inc., in satisfaction of accrued salaries when both before and after the receipt of said stock the individuals each owned 50 percent of the corporation's outstanding stock.

Held further, petitioner Fender Sales, Inc., did not realize taxable income in its fiscal years ended May 31, 1957, and May 31, 1958, since the cancellations of its accrued salary indebtedness to its two shareholders by said shareholders constituted capital contributions.

Held further, petitioner Fender Sales, Inc., failed to prove that the respondent erred in disallowing a portion of the "rental" payments made to Donald D. Randall during the fiscal years ended May 31, 1956, and May 31, 1957.

Paul F. Loveridge, Esq., and *William C. Jordan, Esq.,* for the petitioners.

Edward M. Fox, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION.

FAY, *Judge:* Respondent determined deficiences in petitioners' income taxes for the years and in the amounts as follows:

Docket No.	Petitioner	Year Ended	Deficiency
92757	Fender Sales, Inc.	5/31/56	$53,904.85
		5/31/57	10,220.86
		5/31/58	19,266.36
92758	Donald D. Randall and	12/31/57	8,910.01
	Jean E. Randall	12/31/58	12,025.66
92759	Esther Fender	12/31/56	22,189.99
		12/31/57	8,388.86
		12/31/58	19,341.50
92760	Jean E. Randall	12/31/56	15,917.60
92761	Donald D. Randall	12/31/56	16,073.60
92762	C. Leo Fender	12/31/56	22,189.99
		12/31/57	8,388.86
		12/31/58	19,341.49
947-62	Fender Electric	12/31/56	161.99
	Instrument Co., Inc.	12/31/57	241.86
		12/31/58	1,113.66

There are six issues presented for decision in this proceeding:[2]

1. Whether the full amounts of $30,357.84 and $37,205.04 received by C. Leo Fender as salary bonuses from Fender Electric Instrument Co. in the years 1956 and 1957, respectively, constitute taxable income, notwithstanding C. Leo Fender's subsequent return of

[2]Although the respondent made other adjustments to various income and expense items in each of the seven dockets, the petitioners have assigned no error with respect to many of these items. Consequently, the Court has assumed that such items have been conceded by the respective petitioners.

$22,000 in 1956 and $25,000 in 1957 to Fender Electric Instrument Co.

2. Whether a withdrawal of $40,000 by C. Leo Fender from Fender Electric Instrument Co. in the year 1958 constitutes a taxable dividend or a bona fide loan.

These issues are present in Docket Nos. 92759 and 92762 only.

3. Whether Fender Electric Instrument Co., in accounting for C. Leo Fender's purported return of salary bonuses, understated its salary expense deduction in 1956 and overstated its miscellaneous income in 1957 by the amounts of $22,000 and $25,000, respectively.

This issue is present in Docket No. 947-62 only, and its resolution is dependent upon the disposition of Issue No. 1.

4. Whether Donald D. Randall and C. Leo Fender realized taxable income in 1956 and 1958 upon the receipt of stock from Fender Sales, Inc., in payment of accrued salaries.

This issue is present in Docket Nos. 92758, 92759, 92760, 92761 and 92762.

5. Whether Fendder Sales, Inc., realized taxable income in its fiscal years ended May 31, 1957, and May 31, 1958, as the result of the cancellations of its salary indebtedness to C. Leo Fender and Donald D. Randall.

This issue is an alternative to Issue No. 4 and is present in Docket No. 92757 only.

6. Whether a portion of the airplane rental payments made by Fender Sales, Inc., to Donald D. Randall during the fiscal years ended May 31, 1956, and May 31, 1957, represented nondeductible dividends as distinguished from deductible business expenses.

This issue is present in Docket No. 92757 only.

FINDINGS OF FACT.

Some of the facts have been stipulated, are incorporated herein by this reference, and are found accordingly.

Petitioner C. Leo Fender, hereinafter referred to as Fender, and Esther Fender, are husband and wife with residence in Fullerton, California. Said petitioners make their Federal income tax returns on a calendar year basis and use the cash method of accounting. For the years 1956, 1957 and 1958, Fender and Esther Fender each filed individual Federal income tax returns with the district director of internal revenue at Los Angeles, California.

Petitioners Donald D. Randall, hereinafter referred to as Randall, and Jean E. Randall, are husband and wife with residence at Santa Ana, California. Said petitioners make their Federal income tax returns on a calendar year basis and use the cash method of accounting. For the year 1956, Randall and Jean E. Randall each filed an individual Federal income tax return with the district director of internal revenue at Los Angeles, California. For the years 1957 and 1958 Randall and his wife filed joint Federal income tax returns with the district director of internal revenue at Los Angeles, California.

Petitioner Fender Electric Instrument Co., Inc., hereinafter referred to as Instrument, is a California corporation with its principal place of business in Fullerton, California. Instrument makes its returns for Federal income tax purposes on the calendar year basis, using the accrual method of accounting. For the years

1956, 1957 and 1958, Instrument filed its corporate Federal income tax returns with the district director of internal revenue at Los Angeles, California.

Petitioner Fender Sales, Inc., hereinafter referred to as Sales, is a California corporation with its principal place of business located in Santa Ana, California. Sales makes its returns for Federal income tax purposes on the basis of a fiscal year commencing on June 1 and terminating on May 31, and it uses the accrual method of accounting. For the fiscal years ended May 31, 1956, 1957 and 1958, Sales filed corporate Federal income tax returns with the district director of internal revenue at Los Angeles, California.

Instrument was organized on December 6, 1951, to engage principally in the business of manufacturing musical instruments. Its principal product is an electric guitar invented and developed by Fender. Prior to its incorporation, the business conducted by Instrument had been carried on by Fender as a sole proprietorship. Upon the incorporation of Instrument, Fender transferred to the corporation certain of the sole proprietorship's assets, subject to the sole proprietorship's liabilities, in exchange for the corporation's stock. At all times since the incorporation of Instrument, Fender has been the sole owner of all of its issued and outstanding capital stock. At all times since the incorporation of Instrument, Fender has been the corporation's president, treasurer and chairman of its board of directors; Esther Fender has been the corporation's vice-president and until January 1, 1959, was the corporation's secretary. At all times since the incorporation of Instrument, the corporation's board of directors consisted of Fender, Esther and Lloyd Verry.

Until May 1, 1955, Fender's basic salary for services rendered to Instrument was $500 per month. After May 1955, Fender's basic salary was increased to $1,000 per month. In addition to said basic salary, at all times since the incorporation of Instrument, the board of directors of the corporation authorized the payment to Fender of a yearly salary bonus equal to 5 percent of Instrument's annual sales, which bonus was payable to Fender after the end of the calendar year.

For the year 1955, Fender's bonus amounted to $30,357.84. Said amount was accrued on the books of Instrument as officers' salaries payable and said amount was deducted by Instrument as a business expense on its Federal income tax return for 1955, which return was filed on June 15, 1956.

Under date of January 12, 1956, the minute book of Instrument contains the following entry: "Mr. Fender offered to return to the corporation $22,000.00 of his bonus. Offer to be accepted."

On January 31, 1956, Instrument executed and delivered its check to Fender in the amount of $24,809.43. The amount of $24,809.43 represented Fender's 1955 salary bonus of $30,357.84 less withholdings of $5,548.41. In recording this transaction on its books, Instrument's bookkeeper debited officers' salaries payable with $30,357.84 and credited the cash account with $24,809.43 and the taxes payable account with $5,548.41.

On March 2, 1956, the check payable to Fender in the amount of $24,809.43 was endorsed by Fender, returned to Instrument and deposited by the corporation in its general bank account. No bookkeeping entries were made to record the return of said check until July 31,

1956. In recording the receipt of the check from Fender, Instrument's bookkeeper debited the cash account with $24,809.43 and credited a receivable account (number 6)[3] with $24,058.37.[4]

Even though Fender was the treasurer of Instrument and was vested with final authority over the corporation's books and records, he nevertheless generally disassociated himself from the mechanics of recordkeeping and left such matters up to the bookkeeping department.

Under date of May 7, 1956, the minute book of Instrument contained the following entry: "The President's compensation to be continued at $12,000.00 annually plus a bonus of 5 per cent of sales payable after the end of the calendar year."

For the year 1956, Fender's bonus amounted to $37,205.04. Said amount was accrued on the books of Instrument as officers' salaries payable and said amount was deducted by the corporation as a business expense on its Federal corporate income tax return for 1956.

Under date of January 16, 1957, the minute book of Instrument contained the following entry: "Mr. Clarence L. Fender [C. Leo Fender] offers to return to the corporation $25,000.00 of his bonus. Offer to be accepted."

On January 15, 1957, Fender issued his personal check payable to Instrument in the amount of $25,000. Upon receipt of this check, Instrument's bookkeeper

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[3]Receivable account (number 6) was a clearing account and reflected nonbusiness transactions between Fender and Instrument.

[4]The credit of $24,058.37 instead of $24,809.43 was the result of a bookkeeper's error.

debited the cash account with $25,000 and credited the notes payable account with $25,000.

On January 16, 1957, Instrument executed and delivered its check, apparently erroneously dated January 18, 1957, to Fender in the amount of $30,383.63. The amount of $30,383.63 represented Fender's 1956 salary bonus in the amount of $37,205.04 less withholdings of $6,821.41. This check was endorsed by Fender and deposited in his personal bank account on January 16, 1957.

On March 2, 1956, when Fender returned to Instrument its check for $24,809.43 and on January 15, 1957, when Fender issued his personal check in the amount of $25,000 to Instrument, he gave the bookkeeper no instructions with regard to the manner in which such transactions were to be treated on Instrument's books. The initial entries on Instrument's books reflecting these transactions were the creation of Instrument's bookkeeper.

Instrument employed a public accountant to audit its books, assist its bookkeeper and prepare its income tax returns. In the course of preparing the December 31 closing entries for Instrument's books for the years 1956 and 1957, the public accountant determined that the return of the $24,809.43 check on March 2, 1956, and the receipt of the $25,000 check on January 16, 1957, should be recorded as reductions in Fender's salary rather than as loans to the corporation or as repayments of amounts owed by Fender to the corporation. Th public accountant's decision was based upon his belief that the entries on Instrument's books did not correspond with the action taken in the minutes of January 12, 1956, and January 16, 1957, respectively. The public

accountant advised Fender that in his opinion the bookkeeper had erroneously recorded the transactions and suggested a correction. Fender authorized the public accountant to make any correcting entries he deemed proper. To correct the initial entries in connection with the return of the 1955 salary bonus, the receivable account (number 6) was debited with $22,000 and the officers' salaries expense account was credited with $22,000.[5] To correct the initial entries in connection with the return of the 1956 salary bonus, the amount of $25,000 was eliminated from the notes payable account and treated as an item of miscellaneous income. Fender, prior to being advised by the public accountant, did not know how the bonus return transaction had been handled by Instrument's bookkeeper.

Under date of May 6, 1957, the minute books of Instrument contained the following entry: "The president's compensation to be $12,000.00 annually plus a bonus of 5 per cent of sales payable after the end of the calendar year."

Instrument, although successful, has since its inception operated with a precarious cash position. Because of this chronic financial condition, as well as a particular deficiency of funds during 1956 and 1957, Fender decided that the best way to handle the matter would be for him to return the bonuses. The return of the bonuses, while motivated by Instrument's cash predicament, was a voluntary undertaking on the part of Fender.

On their individual income tax returns for 1956, Fen-

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[5]Although Fender actually returned $24,809.43 of his 1955 bonus, the public accountant in making the correcting entries to Instrument's books used the figure contained in the minutes of January 12, 1956, *i.e.*, $22,000.

der and his wife reported as the total salary income received by Fender from Instrument for said year the amount of $20,357.84, which amount consisted of the basic salary of $12,000 per year plus a bonus of $8,357.84.

On their individual income tax returns for 1957, Fender and his wife reported as the total salary income received by Fender from Instrument for said year the amount of $23,205.04, which amount consisted of basic salary of $11,000[6] plus a bonus of $12,205.04.

On its corporate income tax return for 1956, Instrument claimed a deduction for officers' salaries which was $22,000 less than the actual amount of such officers' salaries paid or accrued for services rendered by officers during 1956.

On its corporate income tax return for 1957, Instrument treated its receipt of $25,000 from Fender during said year as additional miscellaneous income earned during said year.

At the time Instrument was organized in 1951, Fender transferred substantially all of the assets of his sole proprietorship, with the exception of building and land located at 122 Pomona Avenue, Fullerton, California, to the corporation. The building and land retained by Fender were leased by Fender to Instrument for a rent of $300 per month.

Shortly after the commencement of operations by Instrument it became apparent that the Pomona Street property was not adequate for the needs of the business. Accordingly, it was determined that additional land and buildings would be acquired by Fender. The min-

[6]Although Fender's basic salary was $1,000 per month, he did not receive his last monthly salary payment for 1957 until 1958.

utes of the annual stockholder meeting of Instrument held on May 5, 1952, contain the following entry:

> Esther Fender moved the Board of Directors be directed to loan to C. L. Fender up to $11,000.00 for the purchase of land and up to $100,000.00 for the construction of buildings, such buildings to be leased exclusively to Fender Electric Instrument Company, Inc.

On the same day, the board of directors of Instrument passed a resolution authorizing the president of Instrument to carry out the stockholder's directive.

Subsequent to May 5, 1952, real property located on South Raymond Street in Fullerton, California, was purchased in the name—of Fender. Shortly thereafter construction of office and plant buildings, totalling three in number, was commenced on said property. Although title to the land and buildings was in Fender's name, the costs of acquisition and construction were paid by Instrument.

Since October 31, 1952, there has appeared on the books of account of Instrument a receivable account (number 6A) entitled "Advances on Buildings." Said account is used exclusively to record amounts paid by Instrument on construction of new buildings and has always had a debit balance at the end of each year. On the books of Instrument there also appears a receivable account (number 6) which was created in December 1951 and used as a clearing account to record transactions between Fender and Instrument. Debits to this account were posted when the corporation paid noncorporate expenses of Fender, such as his doctor bills, income taxes, etc.; credits were posted when Fender returned salary, bonus or rental payments

to the corporation and when he paid over to the corporation the proceeds of the sale of the Pomona Street property. In each case where a credit entry reflects a return of bonus by Fender, the bonus was reported by Fender as taxable income. Fender returned portions of his salary, bonus and rental payments to Instrument because the latter has since its inception been in a precarious cash position and has been unable to make such payments to Fender without jeopardizing its cash position. The returned bonus, salary and rental payments account for a large portion of the credit balance appearing in account (number 6).

The initial costs of acquisition and construction totalling $30,917.38 of the Raymond Street property were originally debited to account (number 6); later the amount of $30,917.38 was removed from this account and posted to account (number 6A).

The year-end balance of accounts (numbered 6 and 6A) and the net difference in the balances of said accounts for the years 1952 through 1959 were as follows:

Year	Account 6A[7] Debit Balance	Account 6 Credit Balance	Net Difference Debit Balance
1952	$ 54,031.94	$(13,754.47)	$67,786.41
1953	97,657.14	36,157.06	31,500.08
1954	100,915.51	47,044.82	53,870.69
1955	101,910.91	47,416.82	54,494.09
1956	101,910.91	37,671.65	64,239.26
1957	101,910.91	40,793.43	61,117.48
1958	141,910.91	54,881.75	87,029.16
1959	141,910.91	46,512.71	95,398.20

[7]In November 1955 the amount of $2,474.42 was erroneously posted as a debit to account (number 6A). Consequently, this amount has been eliminated and the balances set forth in the above schedule reflect this correction.

Since the end of 1959 Instrument has ceased paying any of the personal expenses of Fender. The balances in accounts (numbered 6 and 6A) at the end of 1959 are the balances existing in said accounts at the present time.

In December 1952, at about the time the first three buildings were nearing completion, Fender and Instrument entered into a lease providing for the rental of the Raymond Street property to Instrument for $720 per month.

Between 1953 and 1955 Fender constructed another building on the Raymond Street property and leased it to Instrument for an additional rent of $240 per month.

On November 1, 1955, Terrafen, Inc., was organized and incorporated under the laws of the State of California. The primary purpose for which Terrafen was incorporated was to own and operate as lessor the real property and buildings located at 500 South Raymond Street in Fullerton, California. In exchange for all of the issued and outstanding stock of Terrafen and for a promissory note dated November 1, 1955, in the principal amount of $54,165.85, Fender transferred to Terrafen said real property and buildings. The opening book entries of Terrafen, in summary form, were as follows:

Assets		
Land	$10,940.00	
Buildings	90,970.91	
Total Assets		$101,910.91

Liabilities and Capital

Depreciation on buildings	$ 6,651.97	
Note payable—Fender	54,165.85	
Capital stock	41,093.09	
Total Liabilities and Capital		$101,910.91

The amount of the promissory note, $54,165.85, represented the difference between accounts (numbered 6 and 6A) on the books of Instrument as of the date of incorporation of Terrafen. Terrafen did not assume any liabilities to Instrument in connection with the transfer to it by Fender of the land and buildings. At all times since its incorporation, Terrafen has leased the land and buildings located at 500 South Raymond Street, Fullerton, California, to Instrument. At all times since its incorporation, Fender has been the sole stockholder of Terrafen.

Prior to September 30, 1956, Terrafen obtained a loan from the United States National Bank of San Diego in the amount of $50,000, which loan was secured by a deed of trust on the land and buildings located at 500 South Raymond Street, Fullerton, California. The $50,000 proceeds of said loan were then paid by Terrafen to Fender in partial discharge of the promissory note for said amount given to Fender on November 1, 1955.

As of February 1, 1956, Instrument commenced paying rentals of $2,125 per month to Terrafen.

The minutes of a meeting of the board of directors of Instrument held on May 5, 1958, contain the following entry:

> Due to the limitation of manufacturing facilities the owner from whom we lease our present

land and buildings has offered to erect additional buildings. Esther Fender moved that the President be authorized to advance up to $50,000.00 to the owners of the property for this purpose.

On October 14, 1958, Instrument issued its check, number 10228, payable to Fender in the amount of $40,000 and the "Advances on Buildings" account was debited $40,000. Immediately prior to this book entry, the "Advances on Buildings" account had a debit balance of $104,385.33. After this book entry was made, the "Advances on Buildings" account had a debit balance of $144,385.33.

Fender executed a promissory note with Instrument as payee, dated October 14, 1958, and in the face amount of $40,000. The note was for 5 years and provided for interest at the rate of 6 percent per annum from October 14, 1958. The interest, however, was not payable until maturity of the note.

Although Fender admitted executing the note, he was extremely vague concerning the time of and circumstances under which it was executed. Furthermore, Fender was not sure where the note was kept after its execution; and Fender's accountant, who was also the accountant for Instrument, did not know prior to 1960 that such a note even existed. The accountant first became aware of the note's existence during a discussion with Fender in connection with certain adjustments to Fender's and Instrument's income tax returns for 1958

which had been proposed by a revenue agent following an audit of said returns.

Although Instrument filed its income tax returns and kept its books on an accrual basis, it did not at the end of each year accrue any interest on the note received from Fender.

After receipt of the check for $40,000, Fender loaned said amount to Terrafen to be used to finance the construction of additional buildings on the South Raymond Street property. The buildings thereafter constructed became the property of Terrafen.

The books of Terrafen show that as of December 31, 1958, Terrafen owed $88,120.09 to Fender. As of April 8, 1959, the amount owed had increased to $108,120.09. Between April 8, 1959, and September 22, 1961, Terrafen's debt to Fender was reduced from $108,120.09 to $7,818.63 by the payment to Fender of $100,301.46 during said period. None of the funds received by Fender from Terrafen were used to pay or reduce his indebtedness to Instrument.

No collateral has been provided or interest paid by Fender at any time on the outstanding balance in account (number 6A). Fender could not recall whether there ever existed a plan for the repayment of amounts withdrawn from Instrument and until just prior to the trial in this proceeding, he had no recollection as to the amount of his alleged indebtedness to Instrument. In fact, Fender admitted that he had never given the matter any thought.

From its inception through the end of the year 1958, Instrument's earned surplus, shown by its books of account, has accumulated the following yearly balances:

Year	Credit Balance
1951	$ 520.08
1952	36,251.93
1953	56,342.26
1954	57,460.61
1955	82,919.52
1956	102,675.86
1957	140,900.20
1958	159,608.44

With the exception of a nontaxable stock dividend of $26,685.52 declared and distributed in 1954, Instrument has not declared or paid any formal dividends with respect to its stock from its inception to the present date.

Sales was organized and incorporated under the laws of the State of California on February 5, 1953, to engage in the business of acting as exclusive sales agent for Instrument. Sales was authorized to issue 2,500 shares of common stock having a par value of $100 per share. On June 1, 1953, Sales issued 200 shares of its common stock as follows:

Name	Number of Shares	Corporate Office (Sales)
Donald D. Randall	50	President
Charles R. Hayes	50	Vice-President
Francis C. Hall	50	Secretary
C. Leo Fender	50	Treasurer

The above four individuals also constituted the original board of directors of Sales.

Sales agreed to pay each of its officers as compensation for their services to the corporation the amount of $15,000 per year. Sales also agreed to pay both Randall and Hayes an additional yearly compensation of 3 percent of the corporation's annual sales.

During each of the fiscal years ended May 31, 1954, and May 31, 1955, Sales accrued on its books of account and deducted on its income tax returns the amount of $60,000, which represented officers' salaries of $15,000 payable to Randall, Hayes, Hall and Fender.

On November 7, 1955, shortly after the death of Hayes, Sales entered into a stock purchase agreement with Hall and the estate of Hayes whereby Sales was to acquire the stock of both Hayes and Hall in return for which it was to give each of them its promissory note for $4 000. The notes were fully discharged by December 6, 1956. The acquired stock has been treated as treasury stock by Sales.

After November 7, 1955, Fender and Randall were the sole shareholders of Sales, each of said individuals owning 50 shares of stock.

On November 15, 1955, Esther Fender and Jean E. Randall were elected to succeed Hayes and Hall as members of the board of directors of Sales. On November 15, 1955, Esther and Jean were elected vice-presidents of Sales, and Fender, who was treasurer of Sales, also was elected secretary of the corporation. Randall continued to hold the position of president of Sales.

On November 22, 1955, Sales agreed to pay Randall and Fender amounts equal to 4 percent and 1 percent, respectively, of the corporation's annual sales as compensation for their services to the corporation. In addi-

tion, Randall and Fender were to continue to receive the amount of $15,000 per year for services rendered. No compensation was paid by Sales to Esther or to Jean.

Sales from its inception has been plagued by a short cash position. This financial predicament has been caused primarily by the fact that Sales must pay for its purchases upon receipt from Instrument and by the fact that it was often required to finance the dealers who purchased its merchandise.

In 1955 Sales found it necessary to seek bank financing. Originally the bank loaned money to Sales on a completely unsecured basis. Later the bank requested various types of security for its loans such as the subordination of other liabilities and personal guarantees from the corporate officers. The bank in addition became concerned about the accrued officers' salary liabilities that appeared on Sales' balance sheet. The bank's concern was attributable to the fact that said liabilities could conceivably represent potential priority claims over the bank's claim. The bank suggested that the aforesaid liabilities be capitalized.

During the fiscal year ended May 31, 1956, Sales accrued on its books of account the amount of $30,000, which amount represented officers' salaries payable in the amounts of $15,000 each to Randall and Fender. Sales deducted said amount of $30,000 on its Federal income tax return for the fiscal year ended May 31, 1956.

As of August 6, 1956, Sales was indebted to Randall and to Fender in the amounts of $45,000 each, representing officers' salaries payable for the fiscal years ended May 31, 1954, 1955 and 1956. On or about

August 6, 1956, Randall and Fender, in order to comply with the bank's request, offered to discharge Sales' liability for salaries due and payable to them by accepting from Sales an additional share of $100 par value common stock for each $100 of salary debt.

On August 6, 1956, the board of directors of Sales resolved to accept the offers by Randall and Fender. After obtaining a permit from the Commissioner of Corporations of the State of California, Sales on December 3, 1956, issued to Randall and to Fender 450 shares each of its $100 par value common stock in discharge and cancellation of its indebtedness of $45,000 owing to each of said individuals. Immediately prior to said issuance, Randall and Fender owned 50 shares each of Sales stock, said 100 shares being the total of all stock issued and outstanding. Immediately subsequent to said issuance, Randall and Fender owned 500 shares each of Sales stock, said 1,000 shares being the total of all stock issued and outstanding. As a result of said issuance, Sales' capital stock account was increased from the amount of $10,000 to $100,000 and its $90,000 liability for salaries owed to Randall and Fender was discharged and cancelled.

During the fiscal year ended May 31, 1957, Sales accrued on its books of account the amount of $30,000, which amount represented officers' salaries payable in the amounts of $15,000 each to Randall and Fender. Sales deducted said amount of $30,000 on its Federal income tax return for the fiscal year ended May 31, 1957.

As of February 3, 1958, Sales was indebted to Randall and Fender in the amounts of $15,000 each, repre-

senting officers' salaries for the fiscal year ended May 31, 1957. On or about February 3, 1958, Randall and Fender offered to discharge Sales' liability for salaries due and payable to them by accepting from Sales an additional share of $100 par value common stock for each $100 of salary debt.

On February 3, 1958, the board of directors of Sales resolved to accept the offers by Randall and Fender. On May 9, 1958, Sales, after receiving its permit to issue additional stock from the Commissioner of Corporations, issued to Randall and Fender 150 shares each of its $100 par value common stock in discharge and cancellation of its indebtedness of $15,000 owing to each of said individuals. On the same date, Sales issued to Randall and Fender 350 shares each of its $100 par value common stock as a stock dividend. Immediately prior to said issuances, Randall and Fender each owned 500 shares of Sales stock, said 1,000 shares being the total of all stock issued and outstanding. Immediately subsequent to said issuances, Randall and Fender each owned 1,000 shares of Sales stock, said 2,000 shares being the total of all stock issued and outstanding. As a result of said issuances, Sales' capital stock account was increased from $100,000 to $200,000, its earned surplus account was decreased $70,000, and its $30,000 liability for salaries owed to Randall and Fender was discharged and cancelled.

At all times since its incorporation Sales has been a financially solvent corporation.

On their individual Federal income tax returns for the years 1956 and 1958, Fender and his wife did not report any amount as taxable income resulting from

Fender's receipt of 450 shares of Sales stock on December 3, 1956, and 150 shares of Sales stock on May 9, 1958.

On their individual Federal income tax returns for the year 1956 and on their joint Federal income tax return for the year 1958, Randall and his wife did not report any amount as taxable income resulting from Randall's receipt of 450 shares of Sales stock on December 3, 1956, and 150 shares of Sales stock on May 9, 1958.

On its corporate Federal income tax returns for the fiscal years ended May 31, 1957, and May 31, 1958, Sales did not report any amount as taxable income resulting from the discharge and cancellation on December 3, 1956, and May 9, 1958, of its indebtedness for officers' salaries payable to Fender and Randall.

For the past 15 years Randall has been interested in flying. He possesses a single-engine, multi-engine, instrument and commercial pilot's license. In 1951 or 1952 Randall purchased his first airplane, a Cessna 140. The Cessna was later traded for a Stinson, and the Stinson was sometime later traded for a 1947 Beechcraft Bonanza.

On June 1, 1953, Randall sold his Beechcraft to Sales and accepted in payment therefor a promissory note in the amount of $7,500.

In April, 1956, Sales returned to Randall the 1947 Beechcraft Bonanza, Model 35, airplane which Randall agreed to accept in full payment of the promissory note in the amount of $7,500 given to him in June 1953. No prior payments had been made on said promissory note.

In April 1956, Randall purchased a new Beechcraft Bonanza, Model G 35, airplane using the 1947 model aircraft as a trade-in thereon. Upon purchasing the new airplane, Randall leased said aircraft to Sales. The terms of said lease required Sales to pay to Randall $1,000 per month rent and also to pay for all operational and maintenance expenses incident to the operation of the airplane.

In January 1957 Randall purchased a new Piper Apache, Model PA 23, airplane using the 1956 Beechcraft Bonanza, Model G 35, airplane as a trade-in thereon. Upon purchasing said Piper Apache airplane, Randall leased said aircraft to Sales. The terms of said lease required Sales to pay Randall $1,000 per month rent and also to pay for all operational and maintenance expenses incident to the operation of the airplane.

In May 1958, Randall purchased a new Piper Apache, Model PA 23, airplane using the 1957 Piper Apache, Model PA 23, airplane as a trade-in thereon. Upon purchasing said Piper Apache airplane, Randall leased said aircraft to Sales. The terms of said lease required Sales to pay to Randall $1,000 per month rent and also to pay for all operational and maintenance expenses incident to the operation of the airplane.

In October 1958, Randall purchased a Piper Cub airplane exclusively for his personal use.

Randall was the only employee of Sales authorized to fly the aircraft leased to said company. He was not, however, paid special compensation for the performance of flying duties.

During the years involved herein the aircraft leased to Sales were used in making trips to see dealers, to

attend trade showings and to conduct sales meetings with Sales' 12 salesmen stationed throughout the country. The aircraft were also used by Randall on occasions when his purpose in flying was not to travel but merely to maintain his flying proficiency. Randall's son accompanied his father on many of such flights. His son soloed as a pilot on September 12, 1958, at the age of 16.

On occasion during the years involved herein, members of Randall's family, i.e., his wife or son, would accompany him while he was flying Sales' aircraft. Among the locations the Randalls visited by plane was Las Vegas, Nevada.

On at least one occasion, Randall flew the Sales' airplane to Gold Beach, Oregon. While there Randall stayed in a cabin called the Anglers and engaged in fishing. While there he telephoned one dealer and saw another in person.

The Federal Aviation Agency requires pilots to maintain an aircraft and engine log. Although Randall kept no formal operations log showing the various flights made with Sales' aircraft, he stated that he did keep a file of flight plans, gas receipts and other items that represented flight time. These records were not submitted into evidence, however.

OPINION.

Issues 1 and 3.

In *North American Oil v. Burnet*, 286 U.S. 417 (1932) the Supreme Court held that a taxpayer is taxable in each year on all of the income received in that year under a claim of right and without restriction as to its use. Relying on this principle, the respondent

contends that since Fender received the Instrument bonus checks in 1956 and 1957 under "an incontrovertible claim of right and had absolute control over the disposition of the amounts," he is taxable on the entire amount of the bonus, and this is so notwithstanding the fact that Fender returned a portion of each bonus to Instrument. Petitioners advance the argument that where in the year of receipt the recipient renounces his right to income and repays the rightful owner, the claim of right doctrine is not applicable and the recipient is not taxed upon the amounts returned.

This Court has adopted and consistently followed the legal proposition that where prior to the close of the taxable year there has been an adjustment of the contract or obligation and a repayment of a portion of the amount received, the tax liability is to be determined on the basis of such adjusted amount. *H. C. Couch,* 1 B.T.A. 103 (1924); *H. B. Hill,* 3 B.T.A. 761 (1926); *Guy Fulton,* 11 B.T.A. 641 (1928); *Albert W. Russel,* 35 B.T.A. 602 (1937); *Willis W. Clark,* 11 T.C. 672 (1948); *Curran Realty Co.,* 15 T.C. 341 (1950). Other courts have adhered to a similar position. See *Skinner Mfg. Co. v. United States,* 8 F.Supp. 741 (Ct. Cls. 1934); *Stern-Slegman-Prins Co. v. Commissioner,* 79 F.2d 289 (C.A. 8, 1935) affirming a Memorandum Opinion of this Court; *United States v. Merrill,* 211 F.2d 297 (C.A. 9, 1954); *Penn v. Robertson,* 115 F.2d 167 (C.A. 4, 1940).

Respondent submits that the aforenoted cases are distinguishable from the instant case in that in the cited cases the adjustments to income were made not only within the recipient's taxable year of receipt but also within the payor's taxable year of deduction. Re-

spondent's position is not well taken. *Willis W. Clark, supra*, contains circumstances nearly identical to the instant case. In that case the taxpayer was the president, director and substantial shareholder in a closely-held electrical construction company. The taxpayer had an employment contract which provided for the payment to him of a salary of $24,000 a year, plus a bonus of 20 percent of the net profits. The contract was for an indefinite term. During 1941 the company paid the taxpayer his base salary of $24,000, plus a bonus of $60,000 which was based on estimated profits for the year. In March 1942 the company paid the taxpayer an additional $34,208.14 based on 1941 profits as actually determined. In its returns for 1941, which were made on an accrual basis and for a calendar year, the company claimed a deduction of $118,204.14 ($24,000 plus $94,204.14). A revenue agent made an examination of the company's 1941 returns a few months after they were filed and recommended the disallowance of a portion of the compensation paid to taxpayer as well as to another employee of the company.

The taxpayer discussed the matter with the other directors and at his suggestion it was agreed that he would refund to the company any compensation for 1941 in excess of that finally allowed by Internal Revenue Service as a deduction. The Internal Revenue Service and the company finally agreed that a compensation to taxpayer of $90,000 for 1941 was reasonable. Pursuant to his understanding with the directors, the taxpayer gave the company his promissory note for $28,208.14, representing the disallowed portion of 1941 compensation. This Court held that under such circumstances the agreement was a modification of his 1939

employment contract and that as a result the taxpayer was taxable in 1942 on only $6,000 of the $34,208.14 of the 1941 bonus paid to him in 1942.

In the instant case, Fender was aware of the precarious cash position of Instrument, the existence of which is stipulated by the respondent, and on or about the time he was to receive his bonus payment in each of the years 1956 and 1957, he offered to return his bonus to the company. The offer was accepted in each instance. Thereafter, in virtually integrated payment-refund transactions, Fender received Instrument's checks and either returned the check, the case in 1956, or issued his personal check to cover the refund in the case of 1957. Under these circumstances *Willis W. Clark, supra,* provides a definite and basically indistinguishable precedent.

Respondent argues however, that Fender never intended to reduce his compensation and that the return of the bonuses represented in the disjunctive a gift to Instrument, a partial repayment of Fender's indebtedness to Instrument, a loan to Instrument or a contribution to Instrument's capital. Taxation is eminently practical, *Tyler v. United States,* 281 U.S. 497 (1930), and from a practical as well as a reasonable standpoint, we do not think such a construction of the acts of the parties is justified. In our opinion, what occurred was tantamount to nothing more than a relinquishment by Fender in the year of receipt of a part of what he was entitled to receive under his contract, and the acceptance of such a relinquishment by Instrument. The offer to relinquish and its acceptance constituted a modification of Fender's contract to the extent intended by the par-

ties. In *H. C. Couch, supra,* at p. 105, we noted under somewhat similar conditions that:

> Salary arrangement between corporations and their principal shareholders and managers in cases like this one, where the manager is expected by his associates to protect the interests and the future prospects of the company even at sacrifice to himself, are and must be at times subject to such modification as may be made by agreement from time to time; * * *

The fact that the bookkeeper of Instrument may have recorded the transaction initially as a loan or repayment of indebtedness is not controlling for tax purposes. *Arcadia Amusement Co.,* 14 B.T.A. 1335, 1337 (1929); *Eakins v. United States,* 36 F.2d 961 (D.C. N.Y., 1930); *Helvering v. Midland Ins. Co.,* 300 U.S. 216 (1937).

In view of what we have previously stated herein, we think the respondent erred in including the portions of the 1955 and 1956 bonuses which were returned by Fender to Instrument in the year in which he received them in Fender's taxable income. We correlatively conclude that for the year 1956 Instrument did not understate its deductions to the extent of $22,000 and that for the year 1957 Instrument did not overstate its taxable income to the extent of $25,000.

Issue 2.

The respondent determined that the $40,000 withdrawn from Instrument by Fender in 1958 did not constitute a bona fide indebtedness but rather constituted a disguised distribution of a dividend. The question whether a particular withdrawal from a corporation

represents a loan or a taxable dividend is one of fact. *Irving T. Bush,* 45 B.T.A. 609 (1941), remanded on other grounds 133 F.2d 1005 (C.A. 2, 1943); *Victor Shaken,* 21 T.C. 785 (1954). In section 316 of the Internal Revenue Code of 1954[8] a dividend is defined, in effect, as any distribution of property made by a corporation to its shareholders out of current or accumulated earnings and profits. Hence, Fender's withdrawal of $40,000 is to be deemed a dividend unless he can affirmatively establish that it was intended to be a loan. *W. T. Wilson,* 10 T.C. 251, 256 (1948), affirmed sub nom. *Wilson Bros. & Co. v. Commissioner,* 170 F.2d 423 (C.A. 9, 1948), certiorari denied 336 U.S. 909); *Carl L. White,* 17 T.C. 1562, 1568 (1952). The courts have generally recognized that while no single factor is determinative of the character of the withdrawal (*Ben R. Meyer,* 45 B.T.A. 228 (1942); *Elliott J. Roschuni,* 29 T.C. 1193, 1201 (1958), affd. per curiam 271 F.2d 267 (C.A. 5, 1959), certiorari denied 362 U.S. 988 (1960); *William C. Baird,* 25 T.C. 387, 393 (1955)), when the withdrawers are in substantial control of the corporation, such control invites a special scrutiny of the situation.

In the instant case, we are of the opinion that the withdrawal of $40,000 by Fender constituted a distribution taxable as a dividend. The record discloses that Fender had absolute control and dominion over Instrument; that Instrument had large accumulated earnings and profits; that Instrument since its incorporation had never declared a taxable dividend; that Fender had not provided any collateral for the note; that no

[8]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954.

interest was ever accrued by Instrument; and that Fender, the maker, was the only one who knew of the promissory note's existence until 1960. In ascertaining Fender's intention with respect to the $40,000 withdrawal, we think it is also proper to consider the circumstances that surround the other withdrawals from Instrument which appear in account (number 6A). In this connection the record discloses that no notes were ever given, no interest was ever paid, nor was any security ever posted by Fender to secure these withdrawals. Furthermore, Fender indicated that he had no knowledge as to how much money he actually owed the corporation, and that he had never given the matter any thought. He admitted that he had no specific plan for repayment of the advances and that although he had received in excess of $100,000 from Terrafen in repayment of its indebtedness to him, he had not applied any of this money to repay his withdrawals from Instrument. The circumstances surrounding the $40,000 withdrawal in corroboration with the circumstances under which previous withdrawals were obtained adequately support respondent's determination that the $40,000 withdrawal was not intended to be a loan but was intended to be for the permanent use of Fender.

Fender in arguing that the $40,000 withdrawal constituted a bona fide loan points out as factors favoring his contention that the amount withdrawn was carried on the books of Instrument as a receivable, that a five-year promissory note providing for the payment of interest was executed, and from time to time repayments were made of the amounts withdrawn.

The fact that the corporation reflected the withdrawals in the form of a receivable is not a controlling

factor and particularly so when the withdrawer is in control of the corporation. *Elliott J. Roschuni, supra; C. W. Murchison,* 32 B.T.A. 32 (1935); *A. W. Mellon,* 36 B.T.A. 977, 1061 (1937). This same reasoning applies to the execution of a promissory note since the execution and collection of the $40,000 note were for all practical purposes under the exclusive dominion of Fender. *Ben R. Meyer, supra.* See also *William C. Baird, supra.* In addition, it is noteworthy that prior to 1960 the note's existence, if it did in fact exist prior to that time, was known only by Fender.

In connection with Fender's contention relating to the effect of various repayments on the bona fides of the withdrawals, it should be noted that such repayments were in fact credits to the account occasioned for the most part by Fender's relinquishment of his rights to certain salary, bonus, or rental payments. Fender's relinquishment of such rights was admittedly caused by Instrument's precarious cash position and its inability to make such payments.

In view of the foregoing, we do not believe Fender has sustained his burden of showing that the withdrawal of $40,000 in 1958 was intended as a bona fide loan. Accordingly, the respondent's determination with respect to this issue is sustained.

Issue 4.

The respondent contends that the receipt of additional stock in Sales in payment of accrued salaries constituted taxable income to Fender and Randall. Petitioners Fender and Randall relying on *Eisner v. Macomber,* 252 U.S. 189 (1920), take the position that since the issuance to them of additional shares of common stock

did not effect any change in their proportionate ownership in the corporation, the receipt of the stock did not give rise to income.

We agree with the petitioners. Fender and Randall were the sole shareholders of Sales regardless of whether they each owned 50 shares or 1,000 shares. Their wealth was no more increased by the issuance of additional shares than if the corporation had caused its stock to be split 20 for 1. The issuance of such additional shares to Fender and Randall did not constitute income to them within the meaning of the 16th amendment to the Constitution regardless of whether it represented a stock dividend or represented compensation for services. *Eisner v. Macomber, supra.* See also *Deloss E. Daggitt,* 23 T.C. 31 (1954).

Our holding in this respect makes it unnecessary to consider the effect of section 305[9] on the stock distribution.

Issue 5.

Respondent contends that if the distributions of common stock to Fender and Randall are held to be nontaxable, then Sales realized taxable income upon the cancellation of salary indebtedness owed to Fender and Randall.

Since the Supreme Court's decision in *Helvering v. Amer. Dental Co.,* 318 U.S. 322 (1943), this Court has held that the voluntary or gratuitous forgiveness of

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[9]SEC. 305 DISTRIBUTIONS OF STOCK AND STOCK RIGHTS.

(a) General Rule.—Except as provided in subsection (b), gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of each corporation, in its stock or in rights to acquire its stock.

a corporate indebtedness by a shareholder of that corporation did not produce taxable income to the corporation. *George Hall Corporation,* 2 T.C. 146 (1943); *McConway & Torley Corporation,* 2 T.C. 593 (1943). In *Lidgerwood Manufacturing Co.,* 22 T.C. 1152 (1954), affd. 229 F.2d 241 (C.A. 2, 1956), certiorari denied 251 U.S. 951 (1956), we held that the voluntary cancellation of the corporation's indebtedness by a shareholder constituted a capital contribution. Other courts have similarly held that the cancellation of a debt owed by a corporate debtor to a stockholder of the debtor does not constitute taxable income to the debtor but is a capital contribution by the creditor. *Lidgerwood Mfg. Co. v. Commissioner,* 229 F.2d 241 (C.A. 2, 1956); *Pennsylvania Electric Company v. United States,* 135 F.Supp. 416 (Ct. Cls., 1955); *Bratton v. Commissioner,* 217 F.2d 486 (C.A. 6, 1954), remanding on other grounds a Memorandum Opinion of this Court. See also Income Tax Regs. 1.61-12(a).

After considering the record in this proceeding in conjunction with the rationale of the aforenoted cases, we have come to the conclusion that the cancellation of Sales' salary indebtedness by Fender and Randall constituted in fact and effect a contribution to capital.

Respondent contends that the cancellation of indebtedness was not voluntary or gratuitous since Fender and Randall in cancelling the indebtedness were reacting to the bank's demands that such indebtedness be eliminated. The absence of a business purpose is not a *sine qua non* of a capital contribution. In accord, *Pennsylvania Electric Co. v. United States, supra,* where the Court of Claims stated that "* * * a contribution to capital of a corporation does not require a donative

intent, in the sense that there should be no business motive in making it, as it is always the proprietor's business motive of making his property more valuable."

Since section 118 provides that "in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer," we hold that Sales did not receive taxable income by reason of the cancellation of its salary indebtedness to Fender and Randall.

Issue 6.

This issue concerns whether the total amounts paid by Sales to Randall for the use of Randall's airplane during the years 1956 and 1957 represent a proper rental expense. The respondent disallowed 12½ percent of the deduction claimed on the ground that said aircraft during the period of its lease in 1956 and 1957 was used by Randall in furtherance of his personal pursuits and enjoyment.

The issue is one of fact, and the respondent's determination is prima facie correct. Although Randall stated that he never used the plane for nonbusiness purposes, he did admit on cross examination that he made occasional flights solely for the purpose of maintaining his flying efficiency and that his son frequently accompanied him on such flights. He also admitted that he made several flights accompanied by his wife to Las Vegas and that on one occasion he flew to Oregon "on business" and did some fishing while there.

Because of the opportunity for abuse, the courts have always looked with careful scrutiny at transactions between a corporation and those in control of it. *Challenge Manufacturing Co.*, 37 T.C. 650, 660 (1962); *Lim-*

ericks, Inc., 7 T.C. 1129 (1946), affd. 165 F. 2d 483 (C.A. 5, 1948); *Stanwicks, Inc.*, 15 T.C. 556 (1950), affd. per curiam 190 F. 2d 84 (C.A. 4, 1951).

Considering Randall's avid interest in flying as well as his numerous trips to vacation and tourist spas accompanied by members of his family, we find it difficult to believe that no more than an inconsequential part of his flying encompassed personal pursuits. See and compare *Rodgers Dairy Co.*, 14 T.C. 66, 73 (1950). Under such circumstances and in the absence of documentary evidence to corroborate the ipse dixit of Randall, we hold that petitioner Sales has not sustained its burden of proving error in respondent's determination. Accordingly, the respondent's disallowance of a portion of the claimed rental deduction for the fiscal years ended May 31, 1956 and 1957 is sustained.

Decisions will be entered under Rule 50.

APPENDIX II.

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit

Commissioner of Internal Revenue, Petitioner, vs. Fender Sales, Inc., Respondent.

Commissioner of Internal Revenue, Petitioner, vs. Donald D. and Jean Randall, Respondents.

Commissioner of Internal Revenue, Petitioner, vs. Esther Fender, Respondent.

Commissioner of Internal Revenue, Petitioner, vs. Jean E. Randall, Respondent.

Commissioner of Internal Revenue, Petitioner, vs. Donald D. Randall, Respondent.

Commissioner of Internal Revenue, Petitioner, vs. E. Leo Fender, Respondent. Nos. 19,074-19,079.

[December 1, 1964]

On Petitions for Review of the Decisions of the Tax Court of the United States

Before: POPE and BARNES, Circuit Judges; THOMPSON, District Judge

THOMPSON, District Judge:

These are petitions by the Commissioner of Internal Revenue for review of decisions of the Tax Court of the United States of which this Court has jurisdiction under Section 7482 of the Internal Revenue Code of 1954 (26 U.S.C. 7482). The Tax Court held neither the corporate taxpayer, Fender Sales, Inc., nor the individual stockholder-taxpayers, Donald D. and Jean Randall, and C. Leo and Esther Fender, liable for a de-

ficiency of income taxes on account of the transactions set forth in the following statement of the case, as made in petitioner's opening brief and concurred in by respondents.

The taxpayer Fender Sales, Inc. was incorporated in 1953 as a California corporation. It was authorized to issue 2,500 shares of common stock with a par value of $100 per share. At the commencement of the events material to this case, only 100 shares were outstanding, 50 of which were held by the taxpayer Donald D. Randall, and the other 50 by the taxpayer C. Leo Fender. Randall and Fender were also employees of Fender Sales and as such, were entitled to receive, as compensation for their services, $15,000 a year plus amounts equal to four per cent and one per cent, respectively, of annual sales.

Fender Sales was the exclusive sales agent for Fender Electric Instrument Co., Inc., a corporation owned entirely by C. Leo Fender.

Although Fender Sales has always been financially solvent, from its inception it has been plagued by a shortage of cash. This financial predicament was brought about primarily because it had to pay for its purchases upon receipt of the merchandise while it was often required to finance the dealers who purchased merchandise from it. Accordingly, in 1955, Fender Sales found it necessary to seek bank financing. Originally the bank did not ask for security for its loan, but later it required the subordination of other liabilities and personal guarantees from the corporate officers. In addition, it became concerned about accrued (but unpaid) officers' salary liabilities that appeared on Fender

Sales' balance sheet; it felt that these liabilities could represent potential priority claims over the bank's claim. To remedy this, the bank suggested that these liabilities be capitalized.

In each of its fiscal years ending May 31, 1954, 1955 and 1956, Fender Sales, which used the accrual method of accounting for federal income tax purposes, accrued $30,000 on its books of account as representing officers' salaries payable, but unpaid, in the amount of $15,000 a year each to Randall and Fender. In each of those years, Fender Sales deducted the $30,000 on its federal income tax return. Accordingly, as of August 6, 1956, Fender Sales owed Randall and Fender each $45,000 for salaries payable for the fiscal years ended May 31, 1954 through 1956.

On or about August 6, 1956, Randall and Fender, in order to comply with the bank's suggestion, offered to discharge Fender Sales' liability for salaries due and payable to them by accepting from Fender Sales an additional share of $100 par value common stock for each $100 of salary debt. On August 6, 1956, the board of directors of Fender Sales, consisting of Mr. and Mrs. Randall and Mr. and Mrs. Fender, resolved to accept the offers by Randall and Fender. After obtaining a permit from the Commissioner of Corporations of the State of California, Fender Sales, on December 3, 1956, issued to Randall and to Fender 450 shares each of its $100 par value common stock in discharge and cancellation of its indebtedness of $45,000 owing to each of them. As a result of this issuance of stock, Sales' capital stock account was increased from $10,000 to $100,000 and its $90,000 liability for salaries owed to Randall and Fender was discharged and cancelled.

During the fiscal year ended May 31, 1957, Fender Sales accrued on its books of account $30,000 which represented officers' salaries payable, but unpaid, of $15,000 each to Randall and Fender. Fender Sales deducted this amount of $30,000 on its federal income tax return for the fiscal year ended May 31, 1957.

On or about February 3, 1958, when Fender Sales was still indebted to Randall and Fender for $15,000 each for salary for the fiscal year ended May 31, 1957, Randall and Fender offered to discharge Fender Sales' liability for salaries due and payable to them by accepting from Fender Sales an additional share of $100 par value common stock for each $100 of salary debt. On February 3, 1958, the Board of Directors of Fender Sales resolved to accept the offers by Randall and Fender. On May 9, 1958, Fender Sales issued to Randall and Fender 150 shares each of its $100 par value common stock in discharge and cancellation of its indebtedness of $15,000 owing to each of these individuals. On the same date, it issued to Randall and Fender 350 shares each of its $100 par value common stock as a stock dividend. As a result, Fender Sales' capital stock account was increased from $100,000 to $200,000, its earned surplus account was decreased $70,000, and its $30,000 liability for salaries owed to Randall and Fender was discharged and cancelled.

On their federal income tax returns for the years 1956 and 1958, Fender and his wife did not report any amount as taxable income resulting from Fender's receipt of 450 shares of Fender Sales stock on De-

cember 3, 1956, and 150 shares of Fender Sales' stock on May 9, 1958. On their federal income tax returns for the year 1956 and on their joint federal income tax returns for the year 1958, Randall and his wife did not report any amount as taxable income resulting from Randall's receipt of 450 shares of Fender Sales' stock on December 3, 1956, and 150 shares of Fender Sales' stock on May 9, 1958. On its corporate federal income tax returns for the fiscal years ended May 31, 1957 and May 31, 1958, Fender Sales did not report any amount as taxable income resulting from the discharge and cancellation on December 3, 1956 and May 9, 1958 of its indebtednesses for officers' salaries payable to Fender and Randall.

The Commissioner determined that the receipt of the stock constituted taxable salary income to Fender and Randall and, alternatively, that if it did not constitute taxable income to them, Fender Sales realized taxable income upon the cancellation of the salary indebtedness. The Tax Court held, however, that the cancellation of the indebtedness and issuance of the stock did not result in taxable income either to Fender and Randall or to Fender Sales. From that holding the Commissioner has sought review by this Court.

It is implicit in the foregong fact statement and is conceded by respondents that the shares of Fender Sales, Inc. issued to each of the shareholders, Fender and Randall, had a fair market value of $100 per share (par value).

TAX LIABILITY OF FENDER AND RANDALL

Cases numbered 19075 to 19079, inclusive, present petitions by the Commissioner to review decisions by the Tax Court that the individuals, Donald D. Randall and his wife, Jean Randall, and C. Leo Fender and his wife, Esther Fender, incurred no income tax liability arising from the transactions related in the statement of facts. The complete rationale of the Tax Court decision is found in the following quotation:

> "Fender and Randall were the sole shareholders of Sales regardless of whether they each owned 50 shares or 1,000 shares. Their wealth was no more increased by the issuance of additional shares than if the corporation had caused its stock to be split 20 for 1. The issuance of such additional shares to Fender and Randall did not constitute income to them within the meaning of the 16th Amendment to the Constitution regardless of whether it represented a stock dividend or represented compensation for services. Eisner v. Macomber, supra. See also Deloss E. Daggitt, 23 T.C. 31 (1954)."

We disagree, and reverse the decision of the Tax Court in these cases.

The stockholder-employees received and accepted capital stock in discharge of the delinquent obligations of the corporation to them for salaries. If these were not equal stockholders to whom the corporation owed equal sums for unpaid salaries, there would be no semblance of a basis for dispute. The law and regulations plainly tax "all income from whatever source derived" (26 U.S.C., §61), and provide: "* * * if a cor-

poration transfers its own stock to an employee * * * as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee." Regulations, §1.61-2(d)(4). Here the parties agree the fair market value of the stock of Fender Sales, Inc. equalled its par value, and the additional stock issued is, in any event, presumptively equal in value to the liquidated obligations discharged. Regulations, §1.61-2(d).

Respondents say this case is different because the taxpayers were stockholders as well as employees and the equal (50-50) stock ownership by Fender and Randall remained equal after the additional stock was issued; and that they, therefore, "received nothing which they did not already possess, i.e., the entire capital stock of Fender Sales, Inc."

But the corporation was a substantially different corporation after the transactions than before. After the transactions on August 6, 1956, for example, the net worth of the company (excluding capital stock as a liability) was increased by $90,000, resulting from the cancellation of the accrued salary indebtedness. The fact is clear that the interests of Fender and Randall in Fender Sales, Inc. were substantially enhanced in value and that they did, in effect, receive something of value constituting taxable income under the Sixteenth Amendment to the Constitution. In this context, Eisner v. Macomber (1920), 252 U.S. 189, is not even apposite, let alone controlling. True, a stock dividend is just a piece of paper and, when issued proportionately to all stockholders, represents nothing of value and does not result in the realization of taxable income. But this is only because the basic net worth of the corporation,

excluding capital stock as a liability, has not been changed. The stockholders have retained an equal interest in the same investment. In our situation, the stockholders have retained an equal interest in a substantially different investment. The Eisner opinion was explicit in pointing out that a stock dividend is "paper certificates that represent an *antecedent* increase in the value of the stockholder's capital interest" (not, as here, a contemporaneous quid pro quo increase thereof), and "merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities" (not, as here, a $90,000 reduction in debts of Fender Sales, Inc. in August, 1956). The obvious differences between the economic interests represented by an unsecured debt as compared with stock ownership need no elaboration.

We interpret Lidgerwood Manufacturing Co. v. Commissioner (2 CCA 1956), 229 F. 2d 241, as supporting our conclusions. In Lidgerwood, the debts which were cancelled arose from loans, and, if paid, would not have represented taxable income to the stockholder. In that case, a sole stockholder cancelled debts, receiving capital stock in exchange, to enable the corporation to obtain bank loans. The debts cancelled were uncollectible and the stockholder-taxpayer claimed bad debt deductions on its income tax returns. The Court rejected the taxpayer's contention that nothing had been received by virtue of the issuance of the additional stock and, denying the bad debt deduction, said:

> "The petitioner contends that since the debts were assumed to be uncollectible, the cancellation of worthless debts and the issuance of stock therefor were meaningless formalities. We disagree.

When a creditor cancels a debt in return for stock, he gives up the right to repayment, however prosperous the debtor may become, and he acquires a right to dividends from future prosperity. If he owns less than all of the debtor's stock, the issuance of additional shares increases his share of possible dividends. If, as here, the creditor owns all the debtor's stock, his share is not increased but he has retained his 100 per cent right to future dividends and, if the cancelled debts had any value whatever, to that extent he has increased his capital investment. It is not entirely clear what the Tax Court meant by its assumption that the debts were 'uncollectible.' Although the petitioner had contended that the subsidiaries were insolvent both before and after the cancellations, no finding of insolvency was made. But even on the assumption that the debtors were insolvent after as well as before the cancellations, wiping out the debts was a valuable contribution to the financial structure of the subsidiaries. It enabled them to obtain bank loans, to continue in business and subsequently to prosper."

Finally, Respondents say, in substance—break the transaction down to its component parts, none of them is a taxable event, therefore in the aggregate, they cannot generate a tax liability. The argument is: First, the receipt by equal stockholders of equal additional shares of capital stock, without more, is nontaxable; second, the forgiveness by a stockholder of the corporation's debt to him is, without more, a contribution to the capital of the corporation which is expressly excluded from the corporation's gross income. Therefore, a

combination of the two cannot impose income tax liability on anyone. The answer is that the argument is a complete non-sequitur. The first statement deals with the tax liability of the individual stockholders and the second with the tax liability of the corporation.

To be persuasive with respect to the tax liability of the individual stockholders. Respondents' contentions should be: First, the acquisition of additional stock in equal proportionate shares is not a taxable event; second, the cancellation of a debt which, if collected, would represent taxable income is not a taxable event; therefore, the two in combination cannot generate tax liability. This Court does not accept the second premise. We are not prepared to hold that the voluntary surrender or forgiveness by a taxpayer of a receivable which, if collected, would represent taxable income, is, in all circumstances, a non-taxable event. We believe the authorities are opposed to such a conclusion.

In Helvering v. Horst, 1940, 311 U.S. 112, the Supreme Court held that the income received on payment of coupons clipped from coupon bonds and given by a father to his son was taxable to the father, and said, in part:

> "Admittedly, not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event, rather than the acquisition of the right to receive it. And 'realization' is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts

basis. Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him. Old Colony Trust Co. v. Commissioner, 279 U.S. 716; Corliss v. Bowers, 281 U.S. 376, 378. Cf. Burnet v. Wells, 289 U.S. 670.

"* * *

"Underlying the reasoning in these cases is the thought that income is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. Cf. Burnet v. Wells, supra.

"* * *

"The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. See, Corliss v. Bowers, supra, 378; Burnet v. Guggenheim, 288 U.S. 280, 283. The tax laid by the 1934 Revenue Act upon income 'derived from . . . wages, or compensation for personal service, of whatever kind and in whatever form paid, . . .; also from interest . . .' therefore cannot fairly be interpreted as not applying

> to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received."

In Lidgerwood (supra), the case in which the taxpayer sought a bad debt deduction in addition to the capital stock received for the cancelled obligation, the Court succinctly said: "If the debtor has received a contribution to capital, the creditor must have made the contribution. Consistency requires that both parties treat it alike."

In Helvering v. Horst, the coupons were actually paid in the year of the gift, and Respondents point to this as a distinguishing feature, claiming the salaries due from Fender Sales, Inc. were never "paid". But, in Horst, the Supreme Court relied on the broader concept of "realization of income" rather than a restricted notion of actual payment for its conclusions, and we think it necessary and logical, in the just administration of the tax laws, that the Courts continue to recognize that a taxpayer may realize the income represented by an account receivable by exercising his rights of control and disposition of it for his economic benefit in ways other than receipt of payment in money. In Commissioner v. Lester, 1961, 366 U.S. 299, 304, the Supreme Court approvingly quoted from Horst: "The power to dispose of income is equivalent to ownership of it." We add, the exercise of the power to dispose of income is

the equivalent of the realization of it. Fortunately, under the agreed facts of this case, we have no problem respecting the taxable value of the income thus realized and no problem respecting the tax year in which the income is reportable.

Randall and Fender, when they voluntarily elected to exercise their dominion and control over the choses in action against Fender Sales, Inc. for unpaid salaries by extinguishing them for the benefit of the corporation, of which they were sole owners, thereby augmenting the intrinsic worth of the capital stock they held, more surely "realized" for their own benefit the value of the obligations discharged than did Horst in his gift of interest coupons to his son.

In summary, we hold that the discharge by a corporation of its salary obligations to any employee (stockholder or not) by the issuance of the corporation's capital stock to the employee is a payment and realization of income by the employee in the amount of the fair market value of the stock. The transaction is controlled by Section 61 of the Internal Revenue Code and Section 1.61-2 of the Regulations. We disagree with the conclusions in Josephson v. Commission, 6 T.C.M. 788 and Daggit v. Commissioner, 23 T.C. 31, cited by Respondents.

The decisions of the Tax Court in cases numbered 19075 to 19079, inclusive, are reversed.

TAX LIABILITY OF FENDER SALES, INC.

Case No. 19074 presents a petition to review the determination by the Tax Court that the corporation, Fender Sales, Inc., incurred no income tax liability by reason of the related transactions.

Although the Commissioner argued for assessing tax liability against the corporation, this was only as an alternative should the individuals be held not liable. The Commissioner's brief states: "For the reasons already shown, we believe that Fender and Randall are taxable on the amounts of the accrued salaries and that Fender Sales is not. We do not contend that both are taxable on the same amounts." Whether viewed as payments for stock of the corporation or as the forgiveness by the shareholders of debts owed to them by the corporation, the transactions were non-taxable payments or contributions to capital from the point of view of the corporation's tax liability. 26 U.S.C. 118; I.R.C. 1032(a); Reg. 1.1032-1; Reg. 1.61-12 (a); Carroll-McCreary Co., Inc. v. Commissioner (2 CCA 1941), 124 F. 2d 203; Helvering v. American Dental Co., 1943, 318 U.S. 322; Commissioner v. Auto Strap Safety Razor Co. (2 CCA 1934), 74 F. 2d 227.

The petition in Case No. 19074 should be dismissed. BARNES, Circuit Judge, dissenting in part and concurring in part:

I respectfully dissent. I would affirm the Tax Court in respect to the nonliability of the individual taxpayers, *i.e.*, cases 19075 to 19079, inclusive.

I deduce the matter that concerns my brothers is the loophole in present laws which allows a corporation whose stock is owned equally by two principals to take

deductions in certain years for accrued salaries payable, never incur actual expenses for such deductions, and then have the liabilities written off without any tax recognition because the item is treated as a capital contribution by the shareholders. If on a balancing of all factors, this method of corporate tax liability reduction is a loophole that should be plugged, then it should be done by legislative action, not by judicial fiat. The majority opinion seeks to remedy the supposed leak by attaching liability to the *individuals* involved by extending the dominion and control cases, represented by *Helvering v. Horst,* 311 U.S. 112 (1940).

This majority opinion is the first I have encountered which recognizes a realization of income by shareholders upon an increase in corporate net worth, *where no dividend has been declared or capital gain yet realized by* the shareholders. Shareholders' interests in corporations change every day. The net worth of corporations is in a constant state of flux. Surely, when it increases, the shareholders are not *yet* deemed to have made a taxable gain. Rather the increase in corporate net worth is merely a paper increase of the shareholders' equity, not taxable until such time as the shareholders realize the increase by virtue of a dividend, or the sale or exchange of the security investment above cost. Then, and only then, have the courts traditionally recognized "a taxable event."

The use of the *Horst* line of cases as authority for recognizing the creation of a taxable event for the individuals in the case at bar is to me misleading. The evasionary device attacked in *Horst* and its progeny was different from the present situation. Those cases involved assignments of income rights to others prior

to the point of realization of the income by the taxpayer himself. Such an anticipatory device by a taxpayer with complete control over the income was clearly a loophole in our tax laws that required plugging. Otherwise a taxpayer could assign his earnings directly to his creditors or family and claim there was never any income realization on his part. The case at bar does not involve a flagrant example of this potential loophole. The taxpayers here have had no benefits *realized* by the issuance of additional stock for the cancellation of a corporate debt; their income has not been *diverted* to anyone else for their own personal benefit. They did not exert any power to dispose of their alleged "income" in a manner equivalent to ownership, and will not do so until the ordinary taxable event occurs—the sale of their stock.

The *Lidgerwood* case, cited, is in my opinion not controlling on the facts of this case. In fact the opinion seems to overlook the corporate nature of the stockholder in that case. The bad debt deduction was disallowed the parent-stockholder, but the cancellation was treated not as income to the parent *or its creditor subsidiaries;* rather it was properly treated as a capital contribution. To the extent the *Lidgerwood* case is relevant to the facts before us, it supports the conclusion that the taxpayers have not yet realized income by the receipt of additional shares of stock (while maintaining their identical proportional interests) for a debt cancellation.

> "This court and others have held that cancellation of a debt owed by a corporate debtor to a stockholder of the debtor does not constitute taxable income to the debtor but is a capital contribution by the creditor. For many years the Treasury Regula-

> tions have so provided. . . . If the debtor has received a contribution to capital, the creditor must have made the contribution. Consistency requires that both parties treat it alike. *Whether the creditor's investment will result in profit or loss to the investor cannot be determined forthwith. Loss, if any is eventually realized, occurs when the investment is closed out; that is, when the shares of stock of the debtor are sold or become worthless.*" (Emphasis supplied.) *Lidgerwood Mfg. Co. v. Commissioner,* 229 F.2d 241 at 242-43 (2nd Cir. 1956).

Another approach to the problem, which to me supports the decision of the Tax Court, is as follows:

The two equal owners of the corporation are cash basis taxpayers. They each work on behalf of the corporation for three years without drawing a salary. Thus each has no current employment income subject to tax. However, the full time services each renders to the corporation are of some value; and are here valued at $15,000 per year. These services have their effect on the corporate performance. Consequently, these gratuitous services result, at the end of three years, in a corporate net worth presumably $90,000 greater than it would have been without their services. If at any time one or both of the individual owners decides to sell his investment, he will be taxed in effect for his gratuitous services because the proceeds from any sale would presumably be $45,000 greater than they would have been had he not contributed his services. He has not taken advantage of any tax loophole that does not already exist. Rather he has just chosen not to take a current salary which would be taxed at ordinary income rates, and has instead increased the value of his in-

vestment to be taxed at a subsequent time at capital gain rates. I contend that, from the individual's standpoint, this is exactly what has occurred in the case at bar.

As to the corporation tax liability (case No. 19074), I would affirm.

Under the Internal Revenue Code and regulations, the corporation did not realize income on account of its issuance of capital stock to Fender and Randall, and did not realize income on account of the cancellation of the salary indebtednesses to Fender and Randall. From the point of view of the corporation, any consideration received by it upon an original issue of its corporate stock, whether more or less than the actual or the stated value thereof, is a receipt of capital, not income. Merten's "Law of Federal Income Taxation," Vol. 7, p. 67; I.R.C. 1032(a); Reg. 1.1032-1.

Also, should we treat the capital stock issued as valueless and view the transactions as the gratuitous forgiveness of the salary obligations of the corporation by the respective stockholder-employees, still the corporation would not thereby have realized taxable income. It is established both by regulation and court decision that the gratuitous forgiveness by a shareholder of a debt owed to him by the corporation represents a contribution to the capital of the corporation and is not taxable income. Regulation 1.61-12(a); *Carroll-McCreary Co., Inc. v. Commissioner*, 124 F. 2d 203 (2nd Cir. 1941). Under the Internal Revenue Code, a contribution to the capital of a corporate taxpayer is expressly excluded from the definition of reportable gross income. 26 U.S.C. § 118. In this case, the corporate obligations which were cancelled were unpaid salary ob-

ligations to the shareholders which had been deducted as operating expenses by the corporate taxpayer in its annual accrual-accounting income tax returns and which, if paid, would have represented taxable income to the shareholder-employees. In dealing with a corporation's possible tax liability arising from the gratuitous forgiveness of a debt by a shareholder, the law makes no distinction on the basis of how the obligation arose, that is, whether or not it arose out of a transaction which had permitted the corporation, in an earlier tax year, to deduct the charge from reportable gross income, or whether or not the obligation, if paid, would have constituted reportable income to the shareholder-taxpayer. The forgiveness of the debt by the shareholder is, in either case, from the viewpoint of the corporate taxpayer, a contribution to capital, and not a taxable event. In *Helvering v. American Dental Co.*, 318 U.S. 322 (1943), the Supreme Court held the forgiveness of interest on notes and of rentals due by non-stockholder creditors to be gifts and capital contributions to a corporation, though "the motives leading to the cancellation were those of business, or even selfish." Also, in *Commissioner v. Auto Strap Safety Razor Co.*, 74 F.2d 227 (2nd Cir. 1934), the court, under regulations like those now prevailing, held the voluntary cancellation by the sole stockholder of a subsidiary corporation of over two million dollars in debts, a portion of which represented expense items previously deducted, such as royalties and interest, to be a non-taxable contribution to the capital of the subsidiary corporation, and said: "When the indebtedness was cancelled, whether or not it was a contribution to the capital of the debtor depends upon considerations en-

tirely foreign to the question of the payment of income taxes in some previous year."

I believe a word or two of further explanation is required. The amounts now being treated as contributions to capital have previously been deducted by the corporation on its accrual-method tax returns. Had the individual taxpayers merely loaned money to the corporation and now cancelled the indebtedness, the cancellation would clearly be a contribution to capital, and such contribution should not be treated as taxable income to the corporation. However, the case at bar involves an indebtedness in the nature of accrued salaries, which, unlike the hypothetical taxpayer loans, have once been deducted from income in prior years, consequently lessening the corporation's tax liability. Where sums have been deducted as expenses in previous years under an accrual method of accounting, and are now forgiven and are no longer corporate liabilities, the corporation ordinarily must add back the amount of the cancellation to its current income. If it need not, a flagrant loophole is created whereby expense deductions are taken without expenses ever being incurred or paid out. I refer to the language in *Helvering v. Jane Holding Corp.*, 109 F.2d 933 (8th Cir. 1940).

> "The above cases recognize the principle that an obligation, once deducted but not paid, represents income when, because of subsequent circumstances, it is cancelled or it may be determined with reasonable certainty that it will never be enforced. None of the cases attach any importance to the means by which the cancellation is effected. That is immaterial, the controlling factors being the previous deductions offsetting income otherwise tax-

able and the subsequent release of the indebtedness before payment.

The Trust filed all of its returns for prior years on the cash basis and never reported as taxable income the interest accrued and deducted by the Corporation. The Trust, through the trustees, has, at all times since its creation, been in a position to determine and dictate the policies of the Corporation. It has chosen to earmark the payments which it received from the Corporation as payments on account of principal and at the same time, throughout the entire period, these payments have been in effect deducted as interest accrued in the Corporation's returns. To now permit this accrued liability, after the forgiveness thereof, to be called surplus and addition to capital without taxing the income actually received by the Corporation would result in an unjustifiable avoidance of tax."

While I agree with Judge Thompson's ultimate conclusion that the company has not realized income by the cancellation of the accrued salaries obligation, I do believe to properly justify that conclusion requires some discussion of the conflicting line of cases dealing with shareholder cancellations of indebtedness where the indebtedness has previously been deducted by the corporation as an operating expense.

Regulation § 1.61-12(a) addresses itself directly to the problem of the cancellation of an indebtedness by a shareholder of a corporation. *Generally*, it maintains that the gratuitous forgiveness of a debt constitutes a contribution to capital, the corporation thus realizing no income. The leading precedent for this line of rea-

soning is *Helvering v. American Dental Co., supra.* In that case, the Commissioner had increased the taxpayer's reported income by the sum of the items of the cancelled indebtedness which had served to offset income in like amounts in prior years. But the Supreme Court held that the gratuitous cancellation of rent and interest due should be deemed a gift and not income.

The leading precedent for the opposing point of view, recognizing income to the taxpayer relieved of an indebtedness, is the later case of *Commissioner v. v. Jacobson,* 336 U.S. 28 (1949), which taxed the difference between the face amount of the taxpayer's personal indebtedness as the maker of secured bonds issued at face value, and a lesser amount paid by him for their repurchase. There was no evidence that there had been a transfer of something for nothing: the seller received the maximum price attainable.

Neither of these cases serves as exact precedent for the situation we have here; the cancellation of accrued salaries which have been deducted by the debtor-corporation in prior years. The leading exponents of the conflicting points of view in the accrued salary cases are *Helvering v. Jane Holding Corp., supra,* in favor of income recognition, and *Carroll-McCreary Co., Inc. v. Commissioner,* 124 F. 2d 303 (2nd Cir. 1941), holding no realization of income from the gratuitous cancellation of debts for unpaid salaries owing to officer-shareholders. The *Jane* case preceded the decision in *American Dental Co., supra,* and the trend of the case law since the latter decision has been to follow *Carroll-McCreary* and hold no income is recognized if there was no consideration given as inducement for the cancellation. The cases have interpreted "gratuitous" for-

giveness of a debt as simply meaning that no consideration was paid by the corporation for release of the debt. The prior deduction of the debt as a corporate expense has been held immaterial to the question of whether a nontaxable capital contribution was effected by the debt release. See, *e.g., In re Triple Z Products, Inc.,* 27 AFTR 1164; *Pondfield Realty Co., Inc.,* 1 TC 217, as reversed without written opinion under the rule in *American Dental Co.* (2nd Cir., September 15, 1943), reported at ¶ 61, 103 P-H 1943 Fed.

In the absence of evidence of consideration passing from Fender Sales, Inc., to the individual shareholders for cancellation of the accrued salaries indebtedness, the above case law supports the conclusion that the corporation did not realize income by the release of the accrued salaries liability, though the corporation had already taken the amount as deduction for expense of doing business.

Any potential loophole that is created by attaching no tax liability to the individuals or the corporation is a product of the legislature's failure to compel the corporation to make an income recognition when their accrued deductions are cancelled. This is an error which the legislature should be called upon to reconsider. It should not be corrected by committing a second error in the preser[illegible]se to offset the first.